91-1309
No. ____

Supreme Court, U.S.
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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1991

CORTEC INDUSTRIES, INC. and
CORTEC HOLDINGS, INC.,

*Petitioners,*

vs.

WESTINGHOUSE CREDIT CORP.,

*Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

## PETITION FOR A WRIT OF CERTIORARI

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## QUESTION PRESENTED

Whether a lender is a statutory seller for purposes of Section 12(2) of the Securities Act of 1933 when, as part of an agreement for and simultaneously with the consummation of the sale of a company, that lender's warrant representing ten percent of the equity of the company is retired in exchange for ten percent of the consideration (over $2,000,000) being paid directly by the purchasers?

## PARTIES TO THE PROCEEDING

In addition to petitioners Cortec Industries, Inc. and Cortec Holdings, Inc.* and respondent Westinghouse Credit Corporation, parties to the proceeding below who were not involved with the appeal to the Second Circuit are the following defendants in the District Court: Sum Holding, L.P.,

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* Pursuant to Rule 28.1, petitioners have no parent companies, subsidiaries or affiliates that have issued shares to the public; however, entities formed by or under the control of Leach McMicking & Company, L.P. are among the principal shareholders of Cortec Holdings, Inc.

Dubin Clark & Company, Inc., Dubin Clark Capital Corp., Ronald N. Dubin, J. Thomas Clark, Jean-Pierre Dammann, Norman J. Yerke, Michael Canipe, Bowles Hollowell Conner & Co. and Ernst & Young.

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IN THE

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Petitioners,

v.

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Respondent.

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PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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Petitioners Cortec Industries,

Inc. ("Cortec") and Cortec Holdings,

Inc. ("Holdings"), plaintiffs below, respectfully pray that a writ of certiorari issue to review a November 8, 1991 decision of the United States Court of Appeals for the Second Circuit, which affirmed in part and reversed in part the judgment of the District Court entered on January 3, 1991, dismissing the securities law complaint against respondent, defendant below, Westinghouse Credit Corporation ("WCC") on the ground that WCC was not a statutory seller under § 12(2) of the Securities Act of 1933 (the "1933 Act"). Review should be granted because the Second Circuit's affirmance that WCC was not an actual seller to petitioners ignores Supreme Court precedent requiring courts to look to the economic realities of transactions in defining the scope of

the Federal Securities laws, opens the door for sellers of securities to structure transactions in such a way as to escape liability for disseminating false and misleading prospectuses, and misconstrues the scope and intent of this Court's opinion in Pinter v. Dahl, 486 U.S. 622 (1988).

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is reported at 949 F.2d 42, and is reproduced at Appendix A. The opinion of the United States District Court for the Southern District of New York is reported at [1991] Fed. Sec. L. Rep. (CCH) ¶ 95,714 (January 3, 1991), and is reproduced at Appendix B.

## JURISDICTION

The opinion of the Second Circuit Court of Appeals was entered on November 8, 1991. No petition for rehearing was sought. Federal jurisdiction is invoked pursuant to 28 U.S.C. § 1331; the jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1)(1988).

## STATUTE INVOLVED

Section 12(2) of the 1933 Securities Act, 15 U.S.C. § 771(2)(1981), provides that:

> Any person who -
>
> * * *
>
> (2) offers or sells a security (whether or not exempted by the provisions of § 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he

> did not know, and in the exercise of reasonable care could not have known, of such untruth or omission
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

## STATEMENT OF THE CASE

### Nature Of The Case

This is an action for rescission or damages based on violations of the federal securities laws and common law by the defendants in connection with Holdings' purchase, through Holdings' wholly-owned subsidiary, Cortec Acquisition, Inc. ("Acquisition"), of all of the outstanding shares of common stock of Cortec at a total cost

of approximately $53 million (the "Transaction"). At the time of the Transaction, respondent WCC held a 10% equity interest in Cortec, in the form of a warrant to purchase 111 shares of Cortec stock.

The complaint alleges that defendants[1/] are jointly and severally liable for the extensive damages petitioners suffered because defendants individually and collectively engaged in a scheme to manipulate and fabricate key financial data, projections, and operating information about Cortec. Defendants gave this false and misleading information to petitioners in an

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1/ In addition to WCC, defendants are Cortec's former shareholders, officers and directors, investment bankers and accountants.

Offering Memorandum and through oral misstatements, and also failed to disclose other material information to petitioners. The Section 12(2) claim against WCC was based on the sale of WCC's stock warrant as part of the overall Transaction, made pursuant to the fraudulent Offering Memorandum and oral misstatements.

**Proceedings Below**

Plaintiffs-petitioners filed the Summons and Complaint on January 10, 1990.

On February 20, 1990, WCC moved to dismiss on the grounds that petitioners failed to state a claim against WCC under either Sections 12(2) or 17(a) of the 1933 Act. The other defendants also moved to dismiss, primarily on the stated basis

that the complaint did not plead their fraudulent conduct and, therefore, the claims under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), with the particularity required by Fed. R. Civ. P. 9(b). These defendants also moved against the Section 12(2) claim.

On January 3, 1991, the District Court decided all of defendants' motions. Although the court dismissed the Section 10(b) claims (with leave to replead)[2/], it sustained petitioners' Section 12(2) claims against all defendants other than WCC. With respect to WCC, however, the District Court dismissed the Section 12(2) claim, without granting

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2/ Petitioners' First Amended Complaint was filed on February 28, 1991.

leave to replead, finding that WCC was not a statutory seller. The court held that, because Cortec was deemed, pursuant to the sales agreement, to have retired WCC's warrant before title to the outstanding Cortec shares passed to petitioners, even though both transactions in actuality took place simultaneously at the same closing, WCC was not a statutory seller to petitioners, but was deemed to have sold the warrant to petitioners' sellers.

On January 28, 1991, Cortec and Holdings filed a Notice of Appeal from the District Court's Order, insofar as it related to the dismissal of WCC from the action on the § 12(2) claim. On November 8, 1991, the United States Court of Appeals for the Second Circuit affirmed in part and reversed

in part the Order of the District Court.

The Court of Appeals essentially decided three issues, only one of which is the subject of this petition: that the technical structure of the Transaction rendered WCC a seller to petitioners' seller, thus insulating WCC from liability under Section 12(2).[3/]

In reaching this conclusion, the Second Circuit misconstrued this Court's ruling and statements. The Court of Appeals stated:

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3/ The Second Circuit also held that: 1) the District Court did not commit error by reviewing certain material outside of the complaint in deciding WCC's Rule 12(b)(6) motion, and 2) petitioners had the right to replead their allegations relating to WCC's role in soliciting the sale of Cortec in order to sustain the Section 12(2) claim against WCC.

As these facts make clear, Westinghouse was a seller to old Cortec, not to plaintiffs. Under Pinter, plaintiffs may not therefore assert a claim against their seller's seller. Moreover, as the nature of the above transaction is undisputed -- petitioners dispute the legal significance that should be given these facts, not the facts themselves -- no facts may be alleged that would cause Westinghouse to be liable under Pinter for § 12(2) "seller" liability.

Plaintiffs' view that were Westinghouse to prevail it would mean that a party could intentionally structure a transaction to avoid exposure under § 12(2) is unpersuasive. It was plaintiffs not the district court who were blind to, as plaintiffs term it, the economic reality of this transaction. It is in the nature of the marketplace that parties take into account the risk of liability under the securities laws --

> and, conversely, the ability to hold those with whom they transact business liable -- when calculating the costs and benefits of entering into a particular transaction. Our decision will not protect those who seek to commit fraud by hiding the fact of their ownership and centralizing their shares in one judgement-proof seller's hands immediately prior to the transfer to the ultimate purchaser, as the petitioners suggest. The instant holding simply follows Pinter on the limits of seller liability under § 12(2). If, in the future, a prospective buyer is unwilling to allow its seller's seller to escape responsibility for potential § 12(2) liability, it must design its deal accordingly. Plaintiffs simply failed to do so here, and cannot now change the terms of the bargain they struck.

949 F.2d at 49-50.

Thus, the Second Circuit affirmed the District Court's ruling that WCC was petitioners' seller's seller, and could escape liability under Section 12(2).

## FACTS

### Background

Petitioners purchased 100% of the equity and all outstanding debt of Cortec on May 12, 1989, for approximately $53 million. Cortec, a manufacturer of pre-engineered metal buildings, is comprised primarily of three divisions: Rib-Roof Industries ("Rib-Roof"), which manufactures and erects metal buildings for mini-storage; Summit Buildings ("Summit"), which manufactures and markets metal building systems to the non-residential low-rise, domestic

construction market; and Inland Buildings ("Inland"), engaged in the same business as Summit.

Prior to the Cortec transaction, Cortec was held by four categories of owners: the defendants affiliated with Dubin Clark & Company, Inc., which had formed Cortec ("the Dubin Clark defendants"); members of the management of Cortec ("the management defendants"); Woodlawn Foundation, a not-for-profit corporation; and WCC, holder of a warrant to purchase 111 shares of Cortec stock for just $111.00, which WCC had received in connection with financing the earlier purchases of the Cortec divisions by the Dubin Clark defendants. The total number of shares owned by these defendants, other then WCC, was 1,000.

The Offering Memorandum

Leach McMicking[4/] became interested in acquiring Cortec after #receiving an offering memorandum prepared by BHC, dated December 13, 1988 (the "Offering Memorandum"). As the complaint alleges, "The Offering Memorandum stated that BHC was acting on behalf of the owners of Cortec, including WCC." (emphasis added).

The Offering Memorandum purported to paint a detailed and accurate picture of Cortec, including its history, its current operations and the industry in general. It gave bright projections of operating income, climbing from $5,194,000 for

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4/ Leach McMicking & Co., L.P. ("Leach McMicking") formed Acquisition and Holdings for purposes of the Transaction.

1988 to $8,155,000 for 1989, and to even higher levels for the '90's. The Offering Memorandum supported those projections with various representations.

During the course of the next two months, various of the defendants repeatedly reassured Leach McMicking that the Offering Memorandum was accurate. Indeed, whenever Leach McMicking raised specific concerns, they were told that any problems were temporary and were already being solved.[5/]

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5/ For example, the issue of outstanding accounts receivable and Cortec's consequent ability to meet projections became a principal focus of negotiations and discussions throughout March of 1989. The defendants strove to assure Leach McMicking that

(Footnote continued on following page)

The Stock Purchase Agreement

A stock purchase agreement was signed by Acquisition and all owners of Cortec, including WCC, on April 11th. The agreement provided that the sale of the WCC warrant was to be essentially simultaneous with the sale of all outstanding stock of Cortec. The sale of the warrant was to take place "[o]n the Closing Date, immediately prior to the Closing," which was scheduled for 10:00 a.m.

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5/ (Footnote continued from previous page)

the situation was being rectified and that the receivables were both collectable and being collected. The defendants also reconfirmed the accuracy of balance sheet projections and certain key items relevant to cash flow. On or about March 27, 1989, after receiving these assurances and Cortec's February 1989 financial statements, Leach McMicking submitted a revised bid for Cortec of $22,500,000, plus repayment of debt, which was accepted.

The agreement further provided, "The purchase price to be paid by the Company for the Warrant shall be determined in the manner set forth in Schedule 1. . ." Schedule 1, entitled "Cortec Sale Cash Distribution," set forth the following distribution of the total consideration to be paid by Petitioners:

| Name | Number of Shares | Stock | Warrant | Non-Compete | $ Total Consideration |
|---|---|---|---|---|---|
| Westinghouse | 111 | -0- | 2,142,361 | -0- | 2,142,361 |
| Sum Holdings | 750 | 12,600,410 | -0- | 1,875,000 | 14,475,410 |
| Yerke | 120 | 2,016,066 | -0- | 375,000 | 2,391,066 |
| Woodlawn Found. | 30 | 504,016 | -0- | -0- | 504,016 |
| Boyer | 20 | 336,011 | -0- | 50,000 | 386,011 |
| Canipe | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Peck | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Herrington | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Gunderson | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Reifenberg | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Grund | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Feely | 10 | 168,005 | -0- | 25,000 | 193,005 |
| Bensted | 10 | 168,005 | -0- | 25,000 | 193,005 |
| TOTALS | 1,111 | 16,803,547 | 2,142,361 | 2,500,000 | 21,442,900 |

This chart, subscribed to by all parties, stated the essential natūre of the Cortec transaction. Acquisition was to pay "Total Consideration" of $21,442,900 for the total equity of Cortec, of which $2,142,361 -- approximately ten percent -- was to go to WCC, proportionate to the "Number of Shares" in which it had an interest, i.e., 111 out of 1,111. The funds were wired directly from Leach McMicking to WCC.

The Sellers' Misrepresentations and Omissions

The Transaction went forward as agreed on May 12, 1989. Acquisition purchased the Cortec shares, and Cortec simultaneously cancelled WCC's warrant. Immediately thereafter,

Acquisition merged into Cortec, which became a wholly owned subsidiary of Holdings.

Claims for Relief

After the closing, it became evident that the Offering Memorandum was riddled with material misstatements and that defendants, through BHC and directly, had misled Leach McMicking repeatedly during negotiations.

a. Accounts Receivable. Contrary to what BHC and other defendants represented, a significant portion of the accounts receivable, some dating back to 1986 and 1987, were unsecured and uncollectable.

b. Income Projections. The profits projected in the Offering Memorandum gave way to losses within

the first quarter of 1989. The losses were concealed in the 1989 monthly financial statements, however, by misleading accounting practices that inflated income by $450,000 for the quarter.

c. Backlog. Although the Offering Memorandum touted the strength of Cortec's backlog, the undisclosed fact was that 10-12% of Cortec's backlog would normally be cancelled during a given year, based on Cortec's experience.

d. Rib-Roof. The Offering Memorandum disclosed none of the critical facts about Rib-Roof that would have shown what a problematic division it was.

e. Expenses. Contrary to the statement in the Offering Memorandum that steel prices were expected to

soften, Cortec experienced, but did not disclose, a 6% price increase on certain steel items prior to the closing.

f. Growth Opportunities. The opportunity for growth referred to in the Offering Memorandum, based on expansion into the Western United States, did not exist. A critical part necessary for such an expansion could not be manufactured at Cortec's California plant due to environmental restrictions, and growth in the West was thus uneconomical to pursue.

The cumulative effect of these misstatements and omissions, as well as others by other defendants, was to lure plaintiffs-petitioners into a $53 million purchase. All of the foregoing facts would have had a bearing on the income and cash flow

projections presented to Leach McMicking -- and since the price was largely based on a multiple of these projections, the defendants' fraud had an enormous impact. Petitioners alleged eight causes of action in their original complaint, including claims under § 10(b) of the 1934 Act and Rule 10b-5, §§ 12(2) and 17(a) of the 1933 Act, common law fraud, RICO, a breach of contract claim, and a negligence claim. WCC was named only in the claims under sections 12(2) and 17(a) of the 1933 Act.

## REASONS WHY THE PETITION SHOULD BE GRANTED

### SUMMARY OF ARGUMENT

In Reves v. Ernst & Young, ____ U.S. ____, 110 S. Ct. 945, 949 (1990), decided two years after Pinter v. Dahl, this Court reaffirmed its oft-stated view that whenever a court must "decide which of the myriad financial transactions in our society come within the coverage" of the securities laws, including both the 1933 and 1934 Acts, the court is not "bound by legal formalisms, but instead take[s] account of the economics of the transaction under investigation." This Court's mandated "commitment to an examination of the economic realities of a transaction" should mandate a recognition in this case of the economic reality that WCC

was, in effect, selling its warrant for 10% of the equity to petitioners for 10% of the purchase price of the Cortec transaction, and that WCC was therefore an actual seller and a statutory seller to petitioners under Section 12(2) of the 1933 Act.

Ignoring the rule of Reves v. Ernst & Young, the Court of Appeals applied a formalistic passage of title test, portraying the retiring of the WCC warrant as a sale to the sellers as opposed to the buyers of Cortec, and thus concluded that WCC was not a statutory seller under Section 12(2). This hypertechnical characterization of WCC's sale of its warrant ignored the straightforward allegations in the complaint and the commercial realities of the Transaction.

The Cortec acquisition was one integrated transaction in which even WCC conceded below that it "undeniably participated." The Transaction consisted of petitioners' purchase of 100% of the company. The Second Circuit's holding that WCC's ten percent somehow does not count for purposes of the securities laws not only ignores well-settled Supreme Court principles by erroneously elevating form over substance, it also opens the door to convenient evasions of securities regulation. The holding below, if allowed to stand, would provide an easy loophole to structure an investment in such a way as to avoid any exposure under the securities laws in the event of a sale. Indeed, if the Court of Appeal's analysis is sustained, the

effect will be to exempt a segment of sophisticated transactions from federal regulation and to frustrate the broad remedial purposes of the statutory scheme.

The Second Circuit's decision rests solely on its misinterpretation of a footnote in this Court's opinion in Pinter v. Dahl, 486 U.S. 622, 108 S. Ct. 2063 (1988), in which the Court stated that remote purchasers (that is, those who purchase from a third party who previously purchased and then resold the defendant's shares) are precluded from bringing actions against remote sellers. In this case, however, WCC was in fact the actual seller of 10% of the company petitioners bought, and received 10% of the consideration for that purchase. Accordingly, there was

nothing remote about the relationship between petitioners and WCC. This Court in Pinter v. Dahl surely did not intend to create the kind of formalistic loophole WCC seeks and the Second Circuit condoned here, where passing title to a dummy intermediate entity for a split second can remove an actual seller from liability under Section 12(2). Quite the contrary, Pinter v. Dahl was primarily concerned with the issue of which persons other than actual sellers could be deemed "statutory sellers", holding that persons who solicited a purchase were within the statute's ambit. It was never intended to eliminate liability of an actual seller like WCC.

## ARGUMENT

### THIS COURT SHOULD GRANT CERTIORARI TO PREVENT PARTIES FROM CIRCUMVENTING THE SECURITIES LAWS BY STRUCTURING TRANSACTIONS IN A MANNER TO EVADE SECTION 12(2) LIABILITY

#### A. The Court of Appeals Ignored Supreme Court Precedent In Holding That WCC Was Not A Statutory Seller Under § 12(2)

The Cortec Transaction was the acquisition of the entire company by petitioners, pursuant to a stock purchase agreement that listed WCC as holder of a 10% interest and recipient of 10% of the total consideration petitioners were obligated to pay. WCC's interest was in the form of a warrant and the agreement provided for a formal transfer of the warrant to Cortec so that it could be immediately cancelled. Based on this structural feature of the overall transaction, WCC asserted and the courts below

adopted the pickwickian position that WCC did not sell its interest to petitioners -- despite the fact that the sale of that interest and the shares of the other 90% of the investors was exactly what the transaction was all about from the beginning. The Second Circuit consciously ignored this economic reality of the Transaction.

Nothing in this Court's recent securities law jurisprudence permits such an elevation of form over substance. Recently, the Court cautioned against such a formalistic approach to the scope of the 1933 and 1934 Acts in Reves v. Ernst & Young, ___ U.S. ___, 110 S. Ct. 945 (1990). There, in deciding whether a particular instrument was a security under the 1934 Act, the Court noted

the obligation of federal courts "'to decide which of the myriad financial transactions in our society come within the coverage of these statutes.'" 110 S. Ct. at 949 (quoting United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848, 95 S. Ct. 2051 (1975)). The Court continued:

> In discharging our duty, we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation (emphasis added).

Id. The Supreme Court then referred to the "commitment to an examination of the economic realities of a transaction." Id.

The "commitment" to examining the substance of any transaction applies whether the issue is what is a security or what is a sale: in either

case, the underlying question is the coverage of the transaction under the securities laws.

Indeed, as noted in Reves, this Court has held in an unbroken line of decisions that an inquiry into "economic realities" is central to a determination of whether the securities laws cover a particular transaction. 110 S. Ct. at 949. This requirement applies equally to the 1933 Act as it does to the 1934 Act. In Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S. Ct. 2297 (1985) ("Landreth"), for example, the Court was faced with the question of whether a sale of an entire business (as is the case here) involved a "security" within the meaning of, and was therefore covered by, the 1933 Act. The Court stressed its long history of

"cases in which it looked to the economic substance of the transaction, rather than just to its form, to determine whether the Acts applied." Id. at 2303.

Moreover, the Second Circuit's rigid, hypertechnical analysis simply does not comport with the Supreme Court's statement that: "[This] Court itself has construed securities law provisions 'not technically and restrictively, but flexibly to effectuate their remedial purposes.'" Pinter v. Dahl, 486 U.S. 622, 108 S. Ct., 2063, 2082 (1988) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151, 92 S. Ct. 1456, 1471 (1972) and S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180, 195, 84 S. Ct. 275, 284 (1963)). As the Court stated in Landreth:

> It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

105 S. Ct. at 2306, n.7 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737, 95 S. Ct. 1917, 1926 (1975)); see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 96 S. Ct. 1375, 1382-1383 (1976).

Although we have not uncovered a Court of Appeals case in direct conflict with the Second Circuit's decision here, numerous courts and at least two other Circuits have looked beyond the technical structure of a transaction and allowed the real party in interest to bring securities law

claims, even if -- as WCC suggested and the Second Circuit found -- under a hypertechnical view such a party was not the purchaser or seller. See, e.g., Grubb v. Federal Deposit Ins. Corp., 868 F.2d 1151, 1161-62 (10th Cir. 1989) (use of holding company to engage in transaction did not deprive owners of holding company of separate 10b-5 cause of action because "remedial purpose of the rule should not be defeated by taking a technical, unrealistic view of what happened in a case"); Norris v. Wirtz, 719 F.2d 256, 259 (7th Cir. 1983) (trust beneficiary had standing to bring § 10(b) case arising from security transaction of the trust because "plaintiff is not a bystander as contemplated in Blue Chip Stamps and to grant standing under these circumstances does not threaten

the concerns expressed in Birnbaum"), cert. denied, 466 U.S. 929 (1984).[6/]

In this instance, the "economic realities" of the transaction alleged in the complaint are that petitioners bought out WCC, which is exactly how the transaction is reflected in

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6/ See also H.B. Holdings Corp. v. Scovill Inc., [1990] Fed. Sec. L. Rep. (CCH) ¶ 95,201 at 95,811 (S.D.N.Y. March 23, 1990) (party who participated in purchase or sale is de facto purchaser regardless of the form taken by the surviving corporation); United Dept. Stores, Inc. v. Ernst & Whinney, 713 F. Supp. 518, 522-24 (D.R.I. 1989) (actual party at risk has standing as de facto purchaser even though their investments were channelled through a corporate entity which purchased the subject stock); Heyman v. Heyman, 356 F. Supp. 958, 966 (S.D.N.Y. 1973) ("in § 10(b) cases courts should not be loath to look behind the legal technicalities of a transaction in order to protect those whose interests the statute was designed to safeguard").

Schedule 1 to the agreement WCC signed. Schedule 1 shows WCC at the top of a list of owners of Cortec, whose interests add up to 100%, each of whom received a pro rata share of the total consideration paid by the buyer. The parties plainly viewed the transaction as a sale by the shareholders and WCC to the buyer. These economic realities were erroneously ignored by the Second Circuit.

B. The Court Below Improperly Relied On Pinter v. Dahl

The Second Circuit's stated reason for disregarding the economic realities of the Transaction was that Pinter v. Dahl, 486 U.S. 622, 108 S. Ct. 2063 (1988), mandated a strict passage of title test. Pinter, however, does not support the Second

Circuit's opinion. In Pinter, this Court was primarily concerned with the issue of what entities other than sellers are potentially within the purview of § 12(1). When the Court did speak to the liability of sellers, it described the traditional buyer-seller relationship as the minimum encompassed by the statute, not the maximum:

> At the very least . . . the language of §12(1) contemplates a buyer-seller relationship not unlike traditional contractual privity. Thus, it is settled that §12(1) imposes liability on the owner who passed title, or other interest in the security, to the buyer for value. Dahl, of course, was not a seller in this conventional sense, and therefore may be held liable only if §12(1) liability extends to persons other than the person who passes title.

108 S. Ct. at 2076 (citation omitted).

This reference to a relationship "not unlike" privity does not mean that the purchaser-seller class is defined only by who passes title to whom. See Wilson v. Saintine Exploration and Drilling Corp., 872 F.2d 1124, 1125 (2d Cir. 1989) (under Pinter, "privity is not essential."). While Pinter did suggest that "a buyer cannot recover against his seller's seller," 108 S. Ct. at 2077, n. 21, this Court's willingness to extend liability to persons beyond those who transfer title to include solicitors goes far to prove that the Court in Pinter did not intend that only those purchasers who obtain title directly from a seller, in a traditional technical privity situation, may assert a Section 12 claim. The Court's footnote cautioning that a

remote seller cannot be held liable to remote buyers under Section 12 stresses that a court must look at the nature of the actual relationship between the buyer and seller. Indeed, one of the Court's stated motivations in holding those who solicit sales liable is that such a person "would be thought by the buyer, to be among those 'from' whom the buyer 'purchased,' even though the agent himself did not pass title." 108 S. Ct. at 2077. Likewise, petitioners certainly thought they were purchasing the warrants from WCC when plaintiffs paid WCC an amount equal to its 10% position, pursuant to the terms of a stock purchase agreement to which they were both parties. See Abell v. Potomac Ins. Co., 858 F.2d 1104, 1114 (5th Cir. 1988) (To answer the

question from whom did the plaintiff buy the security, "we must refer to common usage."), vacated on other grounds, 492 U.S. 914, 109 S. Ct. 3236 (1989).

In short, the Second Circuit's conclusion that Pinter established a bright line test comports with neither the reasoning of the Court in Pinter nor the well-settled line of cases focusing on the economic realities of a given transaction. Certiorari should, therefore, be granted.

C. If Allowed To Stand, The Court Of Appeals' Decision Would Invite Evasion Of The Securities Laws

If the Second Circuit's decision is not reviewed by this Court, it can easily become a license for sophisticated sellers to structure transactions whereby they can wholly

avoid exposure under Section 12(2). For example, a group of potential sellers could employ a false or misleading instrument, centralize their shares in one judgment-proof seller's hands immediately prior to transfer to the ultimate purchaser, and thereby avoid liability unless each of them actively solicited the sale. This is contrary to the principles set forth in Reves and to the broad remedial purposes of the securities laws. See Tcherepnin v. Knight, 389 U.S. 332, 336, 88 S. Ct. 548 (1967). See also Gross v. Diversified Mortgage Investors, 431 F. Supp. 1080, 1093 (S.D.N.Y. 1977) (Court should not exalt "form over substance" in determining sellers or purchasers), aff'd, 636 F.2d 1201 (2d Cir. 1980); Norris v. Wirtz, 719 F.2d

at 260 ("[a]lthough superficially concealed by the form of the transactions, the nexus between the alleged misrepresentations to plaintiff and the securities transactions are there in substance").

Indeed, the Court of Appeals literally turned Section 12(2) (and the basic policy of the securities laws) upside down by rewarding companies who are able to structure their transactions to evade the reach of the securities law and placing the burden on the defrauded purchasers to detect and avoid such transactions. The court stated, "If, in the future, a prospective buyer is unwilling to allow its seller's seller to escape responsibility for potential § 12(2) liability, it must design its deal accordingly." 749 F.2d at 50. We

respectfully submit that neither Congress nor this Court ever intended such a result. This Court should review a ruling which not only countenances, but encourages, sellers to "escape" from the dictates of the Federal Securities laws through creative structuring of transactions.

## CONCLUSION

For the reasons stated above, this petition for certiorari should be granted.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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No. 1456 -- August Term 1990

(Argued May 13, 1991
Decided Nov. 8, 1991)

Docket No. 91-7099

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CORTEC INDUSTRIES, INC. and
CORTEC HOLDINGS, INC.,

Plaintiffs-Appellants,

v.

SUM HOLDING L.P.; DUBIN CLARK & COMPANY, INC.; DUBIN CLARK CAPITAL CORP.; RONALD N. DUBIN; J. THOMAS CLARK; JEAN PIERRE DAMMANN; NORMAN J. YERKE; MICHAEL CANIPE; WOODLAWN FOUNDATION; WESTINGHOUSE CREDIT CORPORATION; BOWLES HOLLOWELL CONNER & CO.; ERNST & YOUNG;

Defendants,

WESTINGHOUSE CREDIT CORPORATION,

Defendant-Appellee.

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Before:
CARDAMONE, WALKER, and FRIEDMAN*
Circuit Judges

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Cortec Industries, Inc., and Cortec Holdings, Inc. appeal from that portion of a judgment of the United States District Court for the Southern District of New York (Haight, J.) entered January 3, 1991, which granted defendant Westinghouse Credit Corporation's motion to dismiss appellants' claim that they violated § 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2), without leave to replead.

Affirmed in part, reversed in part, and remanded.

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* Hon. Daniel M. Friedman, United States Circuit Judge for the Federal Circuit, sitting by designation.

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MICHAEL H. BARR, New York, New York (Mark S. Pomerantz, Sonnenschein Nath & Rosenthal, New York, New York, of counsel), for Plaintiffs-Appellants.

CHRISTOPHER P. HALL, New York, New York (Jane A. Rue, Jones, Day, Reavis & Pogue, New York, New York, of counsel), for Defendant-Appellee.

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CARDAMONE, Circuit Judge:

This appeal from a dismissal made pursuant to Fed. R. Civ. P. 12(b)(6) in a securities fraud action asks what documents a district court judge may consider when disposing of a motion to dismiss a complaint for failure to state a claim. Here in drafting their complaint plaintiffs relied upon documents transmitted to them by defendants, though they neglected to attach these papers to, or incorporate them by reference in, the complaint. When defendants made a Rule 12(b)(6) motion to dismiss utilizing the same documents, plaintiffs insisted the district court not consider them, but instead was required to limit its inquiry regarding the complaint's

viability to its four corners. Plaintiffs' failure to include matters of which as pleaders they had notice and which were integral to their claim -- and that they apparently most wanted to avoid -- may not serve as a means of forestalling the district court's decision on the motion.

Plaintiffs sought damages and rescission of a stock purchase agreement allegedly entered into in violation of the securities laws, civil RICO, and the common law. The United States District Court for the Southern District of New York (Haight, J.) in an opinion and order dated January 3, 1991 dismissed, without leave to replead, plaintiffs' claim that Westinghouse Credit Corporation (Westinghouse) violated § 12(2) of the

Securities Act of 1933 in connection with the sale of Cortec Industries, Inc., finding that the complaint itself demonstrated that Westinghouse was not a statutory seller as that term is defined in § 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2).

BACKGROUND

Cortec is engaged in the business of manufacturing pre-engineered metal buildings, and consists of three divisions: Rib-Roof Industries, Summit Buildings, and Inland Buildings. On May 12, 1989 plaintiffs purchased all of Cortec's stock and its outstanding debt for $53 million. Plaintiffs are "new" Cortec Industries, Inc. and Cortec Holdings, Inc. (Cortec or plaintiffs). Prior to

this transaction "old" Cortec, for purposes of clarification, was held by four different categories of owners: defendants affiliated with Dubin Clark & Company, Inc. that had formed old Cortec, defendants that were current members of old Cortec's management, and the defendant Woodlawn Foundation, a not-for-profit corporation. These defendants together owned 1,000 shares of old Cortec stock. The fourth entity with an ownership interest was defendant Westinghouse, holder of a warrant to purchase 111 shares of old Cortec stock for $111. Westinghouse had received the warrant in connection with its financing of old Cortec's earlier purchase of one of its divisions.

Sometime prior to December 13, 1988 the Dubin Clark and management defendants decided to sell old Cortec and retained the investment banking firm of Bowles Hollowell, Conner & Co. (Bowles) located in Charlotte, North Carolina to assist them in that objective. After Leach McMicking & Co., the parent corporation for the purchasing corporations, received an offering memorandum prepared by Bowles dated December 13, 1988; it became interested in acquiring old Cortec. The offering memorandum contained a broad range of information concerning old Cortec, such as its operation in the industry as a whole, including detailed descriptions and historical analyses of its financial performance, what segment and position it occupied

in the industry, and its projected financial results for 1988, 1989 and subsequent years. The memorandum also contained a series of related representations concerning the growth of old Cortec's business and its prospects, which was used to bolster the various optimistic financial projections.

The offering memorandum led Leach McMicking to pursue the acquisition. Its first offer of $21 million plus repayment of existing debt of nearly $26 million was rejected. After further negotiations and representations from the owners and managers of old Cortec -- referred to in plaintiffs' complaint as the "selling defendants," Leach McMicking submitted a revised offer of $22.5

million together with repayment of debt, which the selling defendants accepted.

The transaction was structured as follows. First, Leach McMicking created three new corporations: plaintiff Cortec Holdings, Inc. (Holdings), a Delaware corporation with its principal office in San Francisco, California; plaintiff Cortec Industries, Inc. (Cortec), a Delaware corporation with its principal office in Milwaukee, Wisconsin and a wholly-owned subsidiary of Holdings; and Cortec Acquisitions, Inc. (Acquisition) another wholly-owned subsidiary of Holdings formed for the purpose of engaging in the transaction at issue in this suit. Second, on April 11,

1989, Acquisition entered into a Stock Purchase Agreement with the selling defendants, Westinghouse and Woodlawn, pursuant to which Acquisition agreed to purchase all the shares of old Cortec and old Cortec agreed to use some of the money paid by Acquisition to purchase and cancel the Westinghouse warrant.

The Stock Purchase Agreement contained certain representations and warranties, as well as certain conditions precedent to plaintiffs' obligations to purchase old Cortec. The representations and warranties were that the sellers had furnished audited financial statements for 1986, 1987 and 1988 prepared in accordance with generally accepted accounting principles and on which the accounting

firm of Ernst & Young, also a defendant in this litigation, had expressed an unqualified opinion to the effect that since January 1, 1989 there had not been any material adverse changes in the business or financial condition of old Cortec, Cortec's personal property was not encumbered except as specified, and the information concerning old Cortec set forth in the Stock Purchase Agreement and other documents furnished or to be furnished by the sellers contained no untrue statements of material facts and did not omit material facts. The conditions precedent included the correctness of any representations and warranties when made and as of the date of closing, and that Ernst & Young would

deliver a "comfort letter" to Acquisition concerning 1989's first quarter financial data.

The comfort letter was sent, no clarifications or alterations of prior representations were made, and the transaction closed on May 12, 1989. And then the third and final step of the transaction occurred: Holdings, through Acquisition, acquired all of old Cortec's shares, and old Cortec purchased and cancelled Westinghouse's warrant. Acquisition was then merged into old Cortec, and "new" Cortec emerged as the surviving corporate entity.

In their complaint, plaintiffs allege they would not have entered into this transaction "if not for defendants' repeated fraudulent or

negligent misrepresentations and omissions concerning old Cortec's financial condition, operations and prospects." The particular misrepresentations fall roughly into three categories: failure to state the true nature of the uncollectability of accounts receivable or to provide for adequate loss reserves; failure to base income projections and financial statements on reasonable assumptions or historical analysis; and a miscellaneous list of items that were not disclosed and which negatively affected old Cortec's actual net worth and future financial stability.

On the basis of these allegations, plaintiffs asserted claims against the following defendants: the selling

defendants, Ernst & Young and Bowles for violations of § 10(b) of the 1934 Securities Act; all defendants, except Ernst & Young, for violation of § 12(2) of the 1933 Securities Act; all defendants for violation of § 17(a) of the 1933 Act; the selling defendants under civil RICO and for common law fraud; Sum Holding -- a Dubin Clark-controlled company that owned 750 shares of old Cortec prior to the transaction -- and former old Cortec president Norman Yerke for breach of contract; and Ernst & Young for negligence.

All the defendants moved under Fed. R. Civ. P. 12(b)(6) to dismiss the complaint for failure to state a claim. The district court's January 3, 1991 opinion consisted of several

parts, only one of which is the subject of this appeal, that is, the part that granted dismissal without leave to replead plantiffs' claim against Westinghouse under § 12(2). Based solely on its perusal of the complaint the district court expressed its view of plaintiffs' claim as follows:

> At the time of the transaction, [Westinghouse] owned a warrant which if exercised entitled [Westinghouse], on conversion, to 111 Cortec shares. The warrant had not been exercised. [Westinghouse] held no Cortec shares. In order to consummate plaintiff's [sic] purchase of Cortec, it was necessary to do something about the [Westinghouse] warrant. The parties to the transaction took care of the matter by having the warrant's issuer, "old" Cortec, request [Westinghouse] to surrender it. [Westinghouse] did so, being compensated by part of the funds paid by plaintiffs. The warrant having been thus disposed of, Acquisition purchased all of the

> issued Cortec shares, "old" Cortec merged into Acquisition, and "new" Cortec emerged as the successor in interest to Acquisition.

The district court rejected plaintiffs' argument that this set of facts could result in any § 12(2) liability for Westinghouse as a seller, stating Westinghouse was at most a seller to plaintiffs' seller, i.e., "old" Cortec, which is insufficient for § 12(2) liability, citing Pinter v. Dahl, 486 U.S. 622, 644 n.21 (1988). The court then considered as an alternative that Westinghouse could be liable under § 12(2) for soliciting plaintiffs' purchase of old Cortec, but rejected the solicitation theory, observing that there was no allegation in the complaint of such solicitation by Westinghouse. The trial court also

held without further explanation that plaintiffs' claim under § 12(2) against Westinghouse should be dismissed without leave to replead. A judgment dismissing plaintiffs' claim against Westinghouse under § 12(2) with prejudice was entered accordingly on January 31, 1991. We reverse and remand to allow plaintiffs an opportunity to replead the solicitation aspect of their § 12(2) claim against Westinghouse, and otherwise affirm the judgment of the district court.

## DISCUSSION

### I. The Scope of Review on a Motion to Dismiss.

In arguing that it could not be characterized as a statutory seller for § 12(2) purposes, defendant Westinghouse attached to its motion papers copies of its warrant, the Bowles' offering memorandum, and the Stock Purchase Agreement. Plaintiffs argued, relying on our opinion in Cosmas v. Hassett, 886 F.2d 8 (2d Cir. 1989), that these documents could not be considered by the district court on a motion to dismiss because they were referred to -- but not attached to nor incorporated by reference -- in plaintiffs' complaint. Westinghouse argued that these documents could be considered under Field v. Trump, 850

F.2d 938 (2d Cir. 1988), cert. denied, 489 U.S. 1012 (1989). Noting the seemingly contradictory positions taken by our decisions, the district court neatly avoided the difficulty by relying solely on plaintiffs' complaint.

On appeal, plaintiffs renew their contention that reliance on these outside materials was improper and insist the district court implicitly did rely on them in dismissing their claims. In light of the trial court's clear statement disavowing any reliance on the documents in question, and the lack of any indication in its opinion to cast that statement into doubt, we reject plaintiffs' assertion. We next address whether the trial court could examine and rely

on the Westinghouse warrant, the Bowles' offering memorandum, and the Stock Purchase Agreement in deciding the Rule 12(b)(6) motion before it.

A brief discussion of the Federal Rules will be helpful in placing this subject in perspective. Every defense to a claim for relief must be asserted in a responsive pleading, if one is required, with seven enumerated exceptions. The seven exception list matter that may be challenged by motion, of which the "failure to state a claim upon which relief can be granted" is the sixth. Fed. R. Civ. P. 12(b)(6). The Rule goes on to state that when a motion is made under Rule 12(b)(6) and "matters outside the pleading are presented to and not excluded by the court, the motion

shall be treated as one for summary judgment and disposed of as provided in Rule 56," giving all parties a reasonable opportunity to present pertinent material under that Rule. See Rule 12(b)(6).

The problem arises when a party seeks to introduce affidavits, depositions or other extraneous documents not set forth in the complaint for the court to consider on a Rule 12(b)(6) motion. We suggested nearly 50 years ago that such motions be treated as motions for summary judgment and disposed of as such. See Samara v. United States, 129 F.2d 594, 597 (2d Cir.), cert. denied, 317 U.S. 686 (1942); Boro Hall Corp. v. General Motors Corp., 124 F.2d 822, 823 (1942), cert. denied, 317 U.S. 695

(1943); Fed. R. Civ. P. 12, 1946 Amendment, Notes of Advisory Committee. This provision of the Rules relating to extraneous material that causes a Rule 12(b)(6) motion to be translated into a Rule 56 motion is now mandatory. See Carter v. Stanton, 405 U.S. 669, 671 (1972) (per curiam).

Case law engrafted some flesh on the bare bones of Rule 12(b)(6). Complaints, for example, are not dismissed unless it appears "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Conley v. Gibson, 355 U.S. 41, 45-46 (1957); accord Hishon v. King & Spalding, 467 U.S. 69, 73 (1984). Because a Rule 12(b)(6) motion challenges the facts alleged on the

face of the complaint, see Ryder Energy Distribution Corp. v. Merrill Lynch Commodities, Inc., 748 F.2d 774, 779 (2d Cir. 1984), or, more accurately, the sufficiency of the statements in the complaint, the question is what matters are to be considered in assessing the complaint's sufficiency.

Rule 10(c) provides: "Statements in a pleading may be adopted by reference in a different part of the same pleading or in another pleading or in any motion. A copy of any written instrument which is an exhibit to a pleading is a part thereof for all purposes." Fed. R. Civ. P. 10(c). Relying on Rule 10(c), we have held that the complaint is deemed to include any written instrument

attached to it as an exhibit or any statements or documents incorporated in it by reference. See Cosmas, 886 F.2d at 13; Goldman v. Belden, 754 F.2d 1059, 1065-66 (2d Cir. 1985).

In addition, we have held that when a plaintiff chooses not to attach to the complaint or incorporate by reference a prospectus upon which it solely relies and which is integral to the complaint, the defendant may produce the prospectus when attacking the complaint for its failure to state a claim, because plaintiff should not so easily be allowed to escape the consequences of its own failure. See I. Meyer Pincus and Assoc. v. Oppenheimer & Co., Inc., 936 F.2d 759, 762 (2d Cir. 1991) (prospectus). Similarly, when a district court

decides a motion to dismiss a complaint alleging securities fraud, it may review and consider public disclosure documents required by law to be and which actually have been filed with the SEC, particularly where plaintiff has been put on notice by defendant's proffer of these public documents. See Kramer v. Time Warner, Inc., _____ F.2d ____, No. 90-9014, slip op. at 5919-20 (2d Cir. June 27, 1991); Fed. R. Evid. 201(e) (party entitled upon timely request to opportunity to be heard regarding propriety of court taking judicial notice).

A finding that plaintiff has had notice of documents used by defendant in a 12(b)(6) motion is significant since, as noted earlier, the problem

that arises when a court reviews statements extraneous to a complaint generally is the lack of notice to the plaintiff that they may be so considered; it is for that reason -- requiring notice so that the party against whom the motion to dismiss is made may respond -- that Rule 12(b)(6) motions are ordinarily converted into summary judgment motions. Where plaintiff has actual notice of all the information in the movant's papers and has relied upon these documents in framing the complaint the necessity of translating a Rule 12(b)(6) motion into one under Rule 56 is largely dissipated.

We turn now to the case at hand. Despite the fact that the documents attached to defendant Westinghouse's

motion to dismiss were neither public disclosure documents required by law to be filed with the SEC, nor documents actually filed with the SEC, nor attached as exhibits to the complaint or incorporated by reference in it, the district court was entitled to consider them in deciding the motion to dismiss. The stock purchase agreement, Bowles' offering memorandum, and the warrant were documents plaintiffs had either in its possession or had knowledge of and upon which they relied in bringing suit. It did not lack notice of those documents; these papers were integral to its complaint. Consequently, though the district court, in light of what it viewed as conflicting precedents in this Circuit, declined

to consider these exhibits, it could have viewed them on the motion to dismiss because there was undisputed notice to plaintiffs of their contents and they were integral to plaintiffs' claim.

II. Dismissal of the Complaint without Leave to Replead.

After evaluating the complaint, the trial court found plaintiffs had, at most, alleged Westinghouse was a seller to plaintiffs' seller -- old Cortec -- and that the complaint had failed to present proof of solicitation of the plaintiffs by Westinghouse. It concluded these allegations were insufficient to create § 12(2) liability against Westinghouse, and therefore dismissed

the complaint in its entirety as to that defendant. Plaintiffs contend it was error to dismiss their § 12(2) claim against Westinghouse, and that at the very least they should have been granted leave to replead.

We begin with a statement of the rule. A party may amend its pleading once as a matter of right before a responsive pleading has been served, otherwise by leave of the court, and such "leave shall be freely given when justice so requires." Fed. R. Civ. P. 15(a). It is the usual practice upon granting a motion to dismiss to allow leave to replead. See, e.g., Ronzani v. Sanofi S.A., 899 F.2d 195, 198 (2d Cir. 1990); Devaney v. Chester, 813 F.2d 566, 569 (2d Cir. 1987); Pross v. Katz, 784 F.2d 455, 459-60 (2d Cir.

1986). Although leave to replead is within the discretion of the district court, refusal to grant it without any justifying reason is an abuse of discretion. See Ronzani, 899 F.2d at 198.

Of course, where a plaintiff is unable to allege any fact sufficient to support its claim, a complaint should be dismissed with prejudice. See, e.g., Spain v. Ball, No. 90-7818, slip op. at 2604 (2d Cir. March 12, 1991) (per curiam). Before deciding therefore whether the district court abused its discretion in denying plaintiffs leave to replead their § 12(2) claim, we must first decide whether plaintiffs can allege any facts sufficient to support that

claim. In order to do so we explore the bases for § 12(2) liability.

A. "Seller" Liability

Section 12(2) of the 1933 Securities Act provides:

> Any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him . . . . (emphasis added).

15 U.S.C. § 771(2) (1988). In Pinter v. Dahl, 486 U.S. 622 (1988), the Supreme Court clarified the meaning of the phrase "offers or sells" under § 12(1) of the 1933 Act. As the

language of §§ 12(1) and 12(2) is identical, the Pinter analysis applies to claims arising under § 12(2) as well. See Wilson v. Saintine Exploration and Drilling Corp., 872 F.2d 1124, 1126 (2d Cir. 1989); Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988). The Supreme Court observed: "At the very least, . . . the language of § 12(1) contemplates a buyer-seller relationship not unlike traditional contractual privity. Thus, it is settled that § 12(1) imposes liability on the owner who passed title, or other interest in the security, to the buyer for value." Pinter, 486 U.S. at 642. The Court explored further what kinds of activity may fall within the definition of "offer" or "sell" in the statute.

To do that it looked to the statute itself, which defines "sale" or "sell" to include "every contract of sale or disposition of a security or interest in a security, for value," and the terms "offer to sell," "offer for sale," or "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C. § 77(b)(3) (1988). The Court therefore concluded that "the range of persons potentially liable under § 12(1) is not limited to persons who pass title." 486 U.S. at 643.

The Supreme Court acknowledged that focusing on these introductory terms -- to define the extent of seller liability -- discussed only a

portion of the topic. See Id. The second clause of § 12(1) provides that only a defendant from whom the plaintiff purchased securities may be liable, and this provision circumscribes the number of potential sellers. Id. at 643-44. As noted in a footnote, "[o]ne important consequence of this provision is that § 12(1) imposes liability on only the buyer's immediate seller; remote purchasers are precluded from bringing actions against remote sellers. Thus, a buyer cannot recover against his seller's seller." Id. at 644 n.21 (emphasis added).

At the time of the subject transaction, Westinghouse owned a warrant which if exercised entitled it, on conversion, to 111 shares of

old Cortec. The warrant had never been exercised. Westinghouse held no shares of old Cortec. In order to consummate plaintiffs' purchase of old Cortec, as we earlier noted, the parties had the warrant's issuer, old Cortec, request Westinghouse to surrender it. Westinghouse did so and was compensated from the funds paid by plaintiffs to old Cortec. The warrant having been extinguished, Acquisition proceeded to purchase all of the issued old Cortec shares, old Cortec merged into Acquisition, and "new" Cortec emerged as the successor to Acquisition.

As these facts make clear, Westinghouse was a seller to old Cortec, not to plaintiffs. Under Pinter, plaintiffs may not therefore

assert a claim against their seller's seller. Moreover, as the nature of the above transaction is undisputed -- plaintiffs dispute the legal significance that should be given these facts, not the facts themselves -- no facts may be alleged that would cause Westinghouse to be liable under Pinter for § 12(2) "seller" liability. Hence, Judge Haight correctly dismissed plaintiffs' § 12(2) claim with prejudice insofar as it was based on seller liability.

Plaintiffs' view that were Westinghouse to prevail it would mean that a party could intentionally structure a transaction to avoid exposure under § 12(2) is unpersuasive. It was plaintiffs not the district court who were blind to,

as plaintiffs term it, the economic reality of this transaction. It is in the nature of the marketplace that parties take into account the risk of liability under the securities laws -- and, conversely, the ability to hold those with whom they transact business liable -- when calculating the costs and benefits of entering into a particular transaction. Our decision will not protect those who seek to commit fraud by hiding the fact of their ownership and centralizing their shares in one judgment-proof seller's hands immediately prior to the transfer to the ultimate purchaser, as plaintiffs suggest. The instant holding simply follows Pinter on the limits of seller liability under § 12(2). If, in the future, a

prospective buyer is unwilling to allow its seller's seller to escape responsibility for potential § 12(2) liability, it must design its deal accordingly. Plaintiffs simply failed to do so here, and cannot now change the terms of the bargain they struck.

B. Solicitation Liability

Pinter declined to read the purchase requirement of § 12 as restricting liability simply to the owner of the security. See Id. at 644. The statutory definition does not exclude, it noted, solicitation of a sale as conduct that may result in liability: Section 12 liability has since the enactment of the Securities Act been applied to brokers and others who solicit securities purchases on a regular basis. So construing § 12's

statutory seller language furthers the purpose of the Act, and a party that successfully solicits a purchase is subject to liability as a statutory seller. Id. at 646. Such liability "extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." Id. at 647. Thus, an offeror of securities may be liable under § 12(2) if it sought to sell the security to benefit itself or the securities' owner financially. See Wilson, 872 F.2d at 1126. In applying these principles to the case at hand, the district court dismissed plaintiffs' claim, finding that aside from the fact that Bowles issued the offering

memorandum on behalf of the owners of old Cortec, there was no allegation that Westinghouse solicited plaintiffs in any fashion or participated in the fraudulent action alleged.

On the contrary, a careful reading of the complaint shows that it alleged Westinghouse held a warrant to purchase 111 shares of "old" Cortec stock that it received in connection with Westinghouse's financing of one of the Cortec divisions, that the offering memorandum stated that Bowles was acting on behalf of the owners of Cortec, including Westinghouse, and that the Stock Purchase Agreement's representations and warranties by Dubin Clark were made on behalf of a number of defendants, again including defendant Westinghouse. Most

important, after alleging that Westinghouse sold its warrant as part of the transaction complained of, plaintiffs further claimed that Westinghouse solicited plaintiffs' purchase of the Cortec shares and the warrant.

Obviously, where a defect in the complaint cannot be cured by amendment, it would be futile to grant leave to amend. See Leonelli v. Pennwalt, 887 F.2d 1195, 1198-99 (2d Cir. 1989). But, we think it an abuse of discretion to deny leave to replead on the solicitation aspect of plaintiffs' complaint. Here, there was a plain allegation that Westinghouse solicited the sale for its own financial interests. The district court's contrary conclusion

incorrectly caused it to vary from the usual practice. Moreover, there is no suggestion from the averments of the complaint that an amendment would not supply the facts required to support the allegations and to cure the defect. Under these circumstances, plaintiffs should be granted leave to replead to assert facts, if such exist, that would show that Westinghouse solicited the purchase of old Cortec for its own financial gain.

CONCLUSION

We affirm the order to dismiss the complaint and to deny leave to replead on § 12(2) seller liability, but reverse the portion of the order insofar as it denied plaintiffs leave to replead their § 12(2) claim alleging Westinghouse solicited their

purchase of old Cortec. The judgment of the district court is accordingly affirmed, in part, reversed, in part, and the case is remanded for further proceedings.

/4984L

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

| | | |
|---|---|---|
| CORTEC INDUSTRIES, and CORTEC HOLDINGS, INC., | : | 90 Civ. 0165 |
| Plaintiffs, | : | MEMORANDUM OPINION AND ORDER |
| -against- | : | |
| SUM HOLDING L.P., DUBIN CLARK & COMPANY, INC., DUBIN CLARK CAPITAL CORP., RONALD N. DUBIN, J. THOMAS CLARK, JEAN-PIERRE DAMMANN, NORMAN J. YERKE, HARRY M. FEELY, III, STEPHEN J. REIFENBERG, JOHN W. BOYER, MICHAEL CANIPE, DALE W. PECK, THOMAS HERRINGTON, DEAN E. GUNDERSON, RAYMOND GRUND, CLARA BENSTED, as personal representative of ESTATE OF DONALD BENSTED, WOODLAWN FOUNDATION, WESTINGHOUSE CREDIT CORP., BOWLES HOLLOWELL CONNER & CO. and ERNST & YOUNG, | : | |
| Defendants. | : | |

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HAIGHT, District Judge:

Plaintiffs purchased the outstanding shares of common stock of a corporation and claim they were defrauded. They bring this action against the corporation's former shareholders, officers and directors, investment bankers, accountants, and warrantholders. They allege claims under § 10(b) of the Securities Exchange Act of 1934; § 20 of the 1934 Act; § 12(2) of the Securities Act of 1933; § 15 of the 1933 Act; § 17 of the 1933 Act; the civil RICO statute, 18 U.S.C. § 1964; and various claims under common law. Jurisdiction is alleged under the federal securities

statutes, the RICO statute, and principles of pendent and ancillary jurisdiction. Defendants now move to dismiss the complaint under Rule 12(b)(6), Fed.R.Civ.P.

Background

Plaintiffs make their allegations upon information and belief, except with respect to their own conduct, documents in their possession, and communications to which they or their privies were parties. The complaint alleges the following.

Plaintiff Cortec Holdings, Inc. ("Holdings") is a Delaware corporation with its principal office located in care of Leach McMicking & Company, LP. ("Leach McMicking") of San Francisco. Leach McMicking formed Holdings for

the purpose of the transaction alleged in the complaint.

Plaintiff Cortec Industries, Inc. ("Cortec") is a Delaware corporation with its principal office in Milwaukee, Wisconsin. Cortec is presently a wholly owned subsidiary of Holdings. Another Holdings wholly owned subsidiary, Cortec Acquisition, Inc. ("Acquisition") was also formed by Leach McMicking for the purpose of engaging in the transaction in suit. Acquisition purchased the shares in question and was then merged into Cortec, with Cortec as the surviving entity. Cortec is engaged in the business of manufacturing pre-engineered metal buildings. It is comprised primarily of three divisions: Rib-Roof Industries, Summit

Buildings, and Inland Buildings. Holdings, through Acquisition, purchased the outstanding shares of Cortec and acquired the company and those three divisions in a purchase consummated on March 12, 1989.

Cortec had acquired Summit Buildings and Inland Buildings through independent acquisitions prior to 1989 by companies or partnerships owned or controlled by defendant Dubin Clark & Company, Inc., including defendant Sum Holding L.P. Summit and Inland design, manufacture and market metal building systems to the non-residential low-rise, domestic building construction market.

Prior to the transaction in suit, Sum Holding, a Delaware limited partnership with its principal office

located in care of Dubin Clark & Company, Inc. in Greenwich, Connecticut, owned 750 shares of Cortec stock prior to the transaction. Dubin Clark & Company, Inc., ("DCI") is a Delaware corporation with its principal office located in Greenwich, Connecticut, as is defendant Dubin Clark Capital Corporation ("DCCC"). DCCC is the general partner of Sum Holding.

Defendants Ronald N. Dubin, J. Thomas Clark, and Jean-Pierre Dammann were at the pertinent times officers and directors of DCI, DCC, and Cortec. Plaintiffs collectively refer to DCI, DCCC, Sum Holding, Dubin, Clark and Dammann as the "Dubin Clark defendants."

Defendants Norman J. Yerke, a Wisconsin resident, was president of Cortec prior to the transaction and owned 120 shares of Cortec stock. Defendants Harry M. Feely, III, Stephen J. Reifenberg, John W. Boyer, Michael Canipe, Dale W. Peck, Thomas Herrington, Dean E. Gunderson and Raymond Grund are residents of Wisconsin. Defendant Clara Bensted as personal representative of the estate of Donald Bensted is the successor in interest of the late Donald Bensted, who was also a resident of Wisconsin. Prior to the transaction, these individual were members of the management of Cortec and its divisions. Boyer owned 220 shares of Cortec stock. The others each owned ten shares. Plaintiffs collectively

refer to Yerke and these other individuals as the "management defendants." Plaintiffs also collectively refer to the management defendants and the Dubin Clark defendants as the "Selling Defendants." Defendant Woodlawn Foundation ("Woodlawn") is a New York not-for-profit corporation which prior to the transaction owned 30 shares of Cortec stock.

Defendant Westinghouse Credit Corporation ("WCC") is a Delaware corporation with its principal office in Pittsburgh, Pennsylvania, which prior to the transaction held a warrant to purchase 111 shares of Cortec stock (the "Westinghouse warrant"). WCC had received the Westinghouse warrant in connection

with its financing of the earlier purchases of the Cortec divisions of the Dubin Clark defendants. Defendant Bowles Hollowell, Conner & Co. ("BHC") is an investment banking firm with its offices located in Charlotte, North Carolina.

Defendant Ernst & Young is the successor in interest to Arthur Young & Company, an accounting firm which was hired by the management defendants, the Dubin Clark defendants, and/or Cortec to provide auditing and other accounting services in connection with the sale of Cortec to plaintiffs. The complaint refers to this defendant as "Arthur Young." Following the form of the caption and the briefs, I shall refer to it as "Ernst & Young," the successor firm.

The complaint alleges that some time prior to December 13, 1988, the Selling Defendants decided to sell Cortec and retained BHC to assist them. BHC prepared a 48-page Offering Memorandum with exhibits dated December 13, 1988 ("the Offering Memorandum"), based on information furnished by the Selling Defendants as well as other materials deemed reliable by BHC. BHC thereafter circulated the Offering Memorandum. A copy of the Offering Memorandum found its way to Leach McMicking.

The Offering Memorandum contained a broad range of information concerning Cortec, its operation in the industry as a whole, including detailed descriptions and analyses of Cortec's historical financial

performance, its industry segment and position, and its projected financial results for 1988, 1989 and subsequent years. In that regard, the Offering Memorandum projected operating income of $5,194,000 for 1988 and $8,155,000 for 1989, after adjustments to eliminate "non-recurring expenses" incurred in the consolidation of the operations and management of the three Cortec divisions. Operating income for the years 1990 and forward was projected to be even higher. Complaint ¶ 20.

To "bolster these projections," the Offering Memorandum contained a series of "related representations concerning the growth of the Cortec business and its prospects." Id., ¶ 21. Those included representations

that (a) Cortec had exceeded in three years the Selling Defendants' goals as set forth in their original five year business plan for the company; (b) Cortec had significant opportunities for growth, especially in Western United States markets due to integration of the western-based Rib Roof business and the eastern-based Summit-Inland business; (c) steel prices were expected to "soften" in 1989; (d) as of October 31, 1988, Cortec enjoyed a substantial "backlog" of orders placed but not yet shipped, which supported a strong sales and cash flow performance for Cortec for the remainder of 1988 and early 1989; (e) Cortec's sales and profit margins were expected to climb following the successful integration of the three

divisions; (f) Cortec exercised excellent control over credit extension and accounts receivable and thus incurred very low bad debt expenses, as witnessed by an estimated bad debt expense for 1988 of only $115,000; (g) Cortec's obligation to pay $1,000,000 under a noncompete agreement with the former owner of Rib-Roof, Stuart Ross, was unsecured and interest-free. Ibid.

The offering memorandum led Leach McMicking to pursue a possible acquisition of Cortec. Its interest "was sparked further by a presentation given by some or all of the Management Defendants on February 8, 1989 in Milwaukee and by ongoing discussions between Leach McMicking, BHC and the Selling Defendants." Complaint,

¶ 22. No further particulars are given with respect to these communications, which are alleged to have led Leach McMicking to offer $21,000,000 for Cortec on February 14, 1989, plus an agreement to repay Cortec's existing debt in the amount of approximately $25,750,000.

The Selling Defendants rejected Leach McMicking's first offer, representing that several other parties had submitted higher bids and were closer to obtaining funding. Between February 14 and 27, 1989, "over the telephone and by other means, the Selling Defendants and BHC made numerous representations" concerning the backlog discussed in the Offering Memorandum. In an effort to induce a higher offer from Leach

McMicking, "they" asserted that the strength of the backlog assured Cortec's projected 1989 budget; that historically Cortec had experienced no cancellations from backlog which could therefore be expected to turn into sales; and that the pricing of the backlog was consistent with achieving the business plan and incorporated acceptable profit margins.

On or about February 27, 1989 Leach McMicking made a revised offer for Cortec of $23,000,000, plus repayment of debt, subject to obtaining financing and other conditions. BHC, "on behalf of the Selling Defendants," agreed to accept the bid if financing were obtained and a definitive agreement signed within the following ten days. ¶ 24. But no

agreement was signed within that ten-day period, in part because Leach McMicking received the January 1989 Cortec financial statements indicating that the actual level of accounts receivable exceeded the projected figure by $1,400,000, including substantial past due accounts. Leach McMicking regarded that new data as of critical importance because an increase in accounts receivable could result in a decrease in cash flow needed to service the acquisition debt. On or about March 20, 1989, Leach McMicking informed "BHC and the Selling Defendants" that this issue of excessive accounts receivable, "along with other problems," was sufficient to deter Leach McMicking from proceeding. ¶ 25.

Throughout March, 1989, and particularly after March 20, "the Selling Defendants and BHC" gave Leach McMicking repeated assurances concerning both the quality and collectability of the accounts receivable: specifically, that Cortec always obtained liens on the product it sold and thus rarely had bad debt losses; that corrective policies were being implemented immediately which would restore the temporarily inflated item of accounts receivable to budgeted levels; and that specified collections were to be made by particular dates. The complaint alleges, without further particularization or detail, that these assurances were given by "the Selling Defendants and BHC...[i]n a

series of telephone communications and meetings, including discussions on or about March 13, 16 and 22, and written correspondence sent through the mails or facsimile wire transmissions..." ¶ 26. The "Selling Defendants" also "reconfirmed" the accuracy of the balance sheet projections, "restated" their expectation that steel prices would soften, and "informed" Leach McMicking that funds totalling $450,000 held by a bonding company as security for completion bonds would be released imminently and be available as cash to make payments on outstanding debt. Ibid. No further details are alleged.

On or about March 22, 1989, Leach McMicking received Cortec's February

1989 statements, showing Rib-Roof's sales to be ahead of projections.

In reliance upon these financial statements and the representations of BHC and the Selling Defendants, Leach McMicking on March 27, 1989 submitted a revised offer of $22,000,000 plus repayment of debt, which offer was revised upward to $22,500,000 "at the Selling Defendants' request." ¶ 28.

On April 11, 1989, Acquisition entered into a Stock Purchase Agreement with the Selling Defendants, WCC and Woodlawn, pursuant to which Acquisition agreed to purchase all the Cortec shares and Cortec agreed to purchase and cancel the Westinghouse warrant. The Stock Purchase Agreement contained certain representations and warranties, as well as certain

conditions precedent to plaintiffs' obligation to purchase Cortec. The representations and warranties were that the sellers had furnished audited financial statements for 1986, 1987 and 1988 prepared in accordance with generally accepted accounting principles and on which defendant Ernst & Young had expressed an unqualified opinion; that since January 1, 1989 there had not been any material adverse changes in the business or financial condition of Cortec or related developments; that Cortec's personal property was not encumbered except in certain specified manners; and that the information concerning Cortec set forth in the Stock Purchase Agreement and other documents furnished or to be furnished

by the sellers contained no untrue statements of material facts and did not omit to state material facts. The conditions precedent contained in the Stock Purchase Agreement included the correctness of any representations and warranties when made and as of the closing; that Ernst & Young would deliver a "comfort letter" to Acquisition concerning the first quarter 1989 financials. ¶¶ 29, 30.

The Stock Purchase Agreement also provided for indemnification by certain defendants for damages suffered by plaintiffs arising out of any breach of the agreement; the consent of the parties to the jurisdiction of this Court; and New York law to govern the agreement. The Stock Purchase Agreement further

provided that DCCC was the duly appointed representative of the Management Defendants, Sum Holding, Woodlawn and WCC, with authority to compromise or settle claims arising under the agreement, and to execute and deliver all documents required by it. ¶¶ 31-34.

In late April 1989, Leach McMicking and plaintiffs received Cortec's March 1989 financial statements, which showed Cortec's sales and operating income to be ahead of budget as well as progress on reducing the accounts receivable. On or about May 9, 1989 Ernst & Young delivered to plaintiffs a "comfort letter" required by the Stock Purchase Agreement concerning Cortec's first quarter 1989 financial results. Ernst

& Young represented that nothing had come to its attention causing it to believe that the financial statements were not in conformity with generally accepted accounting principles applied on a basis substantially consistent with the January 1, 1989 audited financial statement, save for minor irrelevant exceptions. ¶¶ 35, 36.

The transaction closed on May 12, 1989. "Holdings, through Acquisition, acquired all of the Cortec shares and Cortec purchased and cancelled the Westinghouse warrant." ¶ 37.

Plaintiffs allege that they would not have entered into the transaction "if not for defendants' repeated fraudulent or negligent misrepresentations and oçomissions concerning Cortec's financial condition,

operations and prospects." ¶ 38. The particular misrepresentations and omissions are alleged in ¶¶ 39 46. They may be grouped under three headings: Accounts Receivable; Income Projections and Financial Statements; and Miscellaneous.

As to accounts receivable the complaint alleges that: "Defendants made numerous oral and written statements to plaintiffs" to the effect that Cortec's accounts receivable posed no problems. It then alleges that contrary to what the "Selling Defendants" represented, a significant portion of the accounts were uncollectible. "Moreover," the complaint continues, "defendants did not disclose that their projections for collections were unreasonably

optimistic;" instead, "defendants" manipulated Cortec's first quarter 1989 financial statements by writing off uncollectible accounts receivable against the reserves for bad debt, without adequately increasing the reserves to reflect Cortec's historical or expected losses. Specifically, bad debt reserves were reduced during the first quarter of 1989 from approximately $732,000 (4.1 percent of receivables) to approximately $269,000 (1.79 percent of receivables), with the result that the bad debt reserves were reduced to grossly inadequate levels. Uncollectible accounts receivable from sales made prior to the purchase are now expected to exceed Cortec's bad debt reserves by an amount in excess of $1,000,000. ¶ 39.

Ernst & Young failed to insist on an adequate increase in loss reserves to correspond to the increase in sales and to conform with historical bad debt experience, and did not qualify their auditors' opinion to reflect that failure. Additionally, Ernst & Young failed to note in its comfort letter that Cortec had decreased its reserves in the first quarter of 1989 as a percentage of existing accounts receivable. Ernst & Young knew that plaintiffs would rely on the audited financials and the comfort letter in deciding to engage in the purchase. ¶ 40.

As to income projections and financial statements, the Offering Memorandum "contained projections of operating income that were not based

on reasonable assumptions or historical analysis." The "Selling Defendants and BHC" knew this; nevertheless "The Selling Defendants and BHC reassured plaintiffs up to, and even on the date of closing that the 1989 projections were valid," and falsely represented that the projections had been prepared by personnel at the respective Cortec divisions, rather than created "by the Selling Defendants." ¶ 41. Other misrepresentations by "defendants" include preparation of financial statements for the first quarter of 1989 showing income figures predicated on sales recorded prior to shipment, whereas the 1988 financial statement reflected recording of sales as of the time of shipment of the goods, a

change in financial statements not disclosed in the first quarter 1989 financial statements, although it resulted in a significant paper increase in Cortec's sales for the period prior to plaintiffs' purchase, thereby falsely portraying Cortec as being a profitable enterprise as of the time of the purchase. Ernst & Young was aware of Cortec's change in the time of recording sales, and had previously advised "the Selling Defendants" of the impropriety of the practice, but nevertheless issued a comfort letter to plaintiffs concerning that the first quarter 1989 financial statements were prepared in accordance with generally accepted accounting principles and in a manner

consistent with prior annual statements. ¶ ¶ 42-44.

The miscellaneous misrepresentations and omissions set forth a lengthy list of false statements or failures to state facts concerning a number of aspects of Cortec's affairs or those of its divisions. These relate to representations concerning the backlog; representations or omissions concerning Rib-Roof's inventory and unpaid bills; the earlier acquisition of Rib-Roof by Cortec and certain features incident to that purchase; a falling off of Inland's orders during the first quarter of 1989 disability of a key salesman; misrepresentations concerning the price of steel; misrepresentations concerning Cortec's

opportunities for expansion in the western United States, coupled with a failure to disclose that the expansion was unrealistic because environmental restrictions prevented manufacture of a critical part necessary for that expansion; misrepresentations that $450,000 listed as security for completion bonds on uncompleted projects would be released immediately, when in fact they have yet to be released; and a failure to disclose an overpayment of $65,000 in management fees for the period January 2 through May 11, 1989. ¶ 45.

In alleging these additional misrepresentations and omissions, the complaint sometimes ascribes them to "defendants"; at other times to the "Selling Defendants and BHC;" and at

other times to the "Selling Defendants" alone. These groupings are used interchangeably.

On the basis of these allegations, plaintiffs assert claims against the Selling Defendants, Ernst & Young and BHC for violations of § 10(b) of the 1934 Act (first and second causes of action); against all defendants except Ernst & Young for violation of § 12(2) of the 1933 Act (third cause of action); against all defendants for violation of § 17(a) of the 1933 Act (fourth cause of action); against the Selling Defendants under civil RICO (fifth cause of action); against the Selling Defendants and BHC for common law fraud (sixth cause of action); against Sum Holding and Yerke for breach of contract (seventh cause of

action); and against Ernst & Young for negligence (eighth cause of action).

All defendants move under Rule 12(b)(6) to dismiss the complaint for failure to state a claim.

Discussion

The Claims Under § 17(a) of the 1933 Act

Plaintiffs assert claims against all defendants under § 17(a) of the 1933 Act. I dismiss those claims because that section of the statute does not create a private right of action.

In Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978), cert. denied, 442 U.S. 909 (1979), the Second Circuit held that a private cause of action is available under § 17(a). The Second Circuit reasoned

in Kirshner that § 17(a) was essentially identical to § 10(b) of the 1934 Act where a private cause of action was implied. 603 F.2d at 241. However, as the Second Circuit recently recognized in Wexner v. First Manhattan Co., 902 F.2d 169, 173 (2d Cir. 1990), that determination "has been severely, and perhaps fatally, undercut by the Supreme Court's ruling to the contrary in Aaron v. SEC, 446 U.S. 680 (1980)."

As Wexner goes on to observe, the reasoning of Kirshner has been questioned by subsequent Second Circuit opinions, Yoder v. Orthomolecular Nutrition Institute, Inc., 751 F.2d 555, 559 n. 3 (2d Cir. 1985); Zerman v. Ball, 735 F.2d 15, 23 (2d Cir. 1984); has been criticized by

legal scholars; and a number of district courts of the circuit have concluded, notwithstanding Kirshner, that no private cause of action can be implied from § 17(a). See district court cases collected at 902 F.2d 174. While leaving the question open, the Wexner court said at 174: "It is apparent that the vitality of our holding in Kirshner is in doubt, and the existence of a private right of action under § 17(a) is in need of examination."

This Court has previously held that § 17(a) confers no private cause of action. Ackerman v. Clinical Data. Inc., No. 84 Civ. 5400, 1985 WL 1884 (S.D.N.Y. 1985) (LEXIS, GENFED library Dist. file). The Second Circuit in Wexner cited Ackerman among the

district court opinions collected at 902 F.2d 174. Given the Second Circuit's recent questioning of Kirshner's vitality, I see no basis for departing from the conclusion I reached in Ackerman.

The § 17(a) claims against all defendants will be dismissed without leave to replead.

The Claim Against WCC Under § 12(2) of the 1933 Act.

The second claim plaintiffs allege against WCC is made under § 12(2) of the 1933 Act. This statute provides in pertinent part:

> Any person who ... offers or sells a security ... by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under

> which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him ...

In Pinter v. Dahl, 486 U.S. 622 (1988), the Supreme Court defined the concept of "seller" under § 12(1) of the 1933 Act. The Second Circuit applies the Pinter analysis to claims arising under § 12(2) as well. See Wilson v. Saintine Exploration and Drillig Corp., 872 F.2d 1124, 1126 (2d Cir. 1989); Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988). In the case at bar, WCC argues that it cannot in law be regarded as a § 12(2) "seller" of the warrants which Cortec purchased in the transaction. I agree.

First it is pertinent to observe that plaintiffs' briefs in opposition to the several motions to dismiss clear up a possible ambiguity in the complaint as to who plaintiffs really are. That ambiguity results from the existence of a pre-transaction Cortec and a post-transaction Cortec. Plaintiffs' brief in opposition to Ernst & Young's motion to dismiss contains this clarification of who "plaintiffs" are:

> The purchaser under the stock purchase agreement was Cortec Acquisition, Inc. ("Acquisition"), an entity formed by Leach McMicking & Company, L.P. ("Leach McMicking") as a vehicle for purposes of acquiring Cortec. Acquisition was a subsidiary of Cortec Holdings, Inc. ("Holdings"), also formed by Leach McMicking for the Cortec transaction. Upon Acquisition's purchase of Cortec, Acquisition merged

> into Cortec, which became a direct subsidiary of Holdings (Complaint, ¶ 5). For purposes of this motion, Holdings, Cortec (as successor in interest to Acquisition), and Leach McMicking are referred to as plaintiffs.

In other words, that party plaintiff bearing the name "Cortec" is the new, post-transaction Cortec, and not the old, pre-transaction Cortec. This makes a difference for § 12(2) statutory seller analysis.

In arguing that it cannot be characterized as a statutory seller, WCC attaches to its motion papers copies of the warrant, the Offering Memorandum, and the Stock Purchase Agreement. Plaintiffs say these documents cannot be considered on a motion to dismiss because they were not physically attached to the

complaint or sufficiently incorporated by reference therein. Plaintiffs rely upon Cosmas v. Hassett, 876 F.2d 8, 11 (2d Cir. 1989), which arose on a motion to dismiss a claim under § 10(b) of the 1934 Act. The Court of Appeals held that the district court committed error by considering an annual report and a Form 10K which were not attached as exhibits to the complaint. Nor, in the court of appeals' view, were these documents incorporated by reference: "The amended complaint merely discussed these documents and presented short quotations from them. '[L]limited quotation does not constitute incorporation by reference."' Id at 13 (citing and quoting Goldman v. Belden, 754 F.2d 1059, 1066 (2d Cir. 1985)).

WCC says I may consider these documents on the authority of Field v. Trump, 850 F.2d 938 (2d Cir. 1988), cert. denied, 109 S.Ct. 1022 (1989). In Field shareholders brought an action under the Williams Act and the 1934 Act alleging fraud in various documents relating to a tender offer and an earlier proxy statement. The case arose on defendants' motion to dismiss under Rule 12(b)(6). The court of appeals said at 949: "In determining whether these claims were properly dismissed under Rule 12(b)(6), we may of course refer to the Offer of Purchase and the 1984 proxy statement, which were annexed to defendants' motion to dismiss and are documents that are integral to plaintiff's claims." (citations

omitted). See also Furman v. Cirrito, 828 F.2d 898, 900 (2d Cir. 1987). A number of district courts have cited Field in support of their consideration on motions to dismiss of documents not attached to the complaint, either on the theory of incorporation by reference or of integral relationship to plaintiff's claim or an amalgam of the two. See Feder v. McFadden, 698 F. Supp. 47, 50 (S.D.N.Y. 1988); Lewis v. Potlatch Corp., 716 F. Supp. 807, 809 (S.D.N.Y. 1989); Ballan v. Wilfred American Educational Corp., 720 F. Supp. 241, 246-47 (E.D.N.Y. 1989).

I have difficulty reconciling the Second Circuit's opinion in Field with that in Cosmas, which seems to return to a more restrictive concept of what

may be considered on a motion to dismiss. Certainly in the case at bar the Offering Memorandum and Stock Purchase Agreement, referred to throughout the complaint although not attached to it, are integral to the plaintiffs' claims. That would argue for my considering them, under Field and the district court cases following Field. It may be that the Cosmas court did not regard the documents in that case as sufficiently integral to that plaintiff's claims. But I need not pursue the subject further, because the complaint itself, clarified as to the status of plaintiffs by their own briefs demonstrates that WCC is not a statutory seller.

All the complaint alleges about WCC is that prior to the transaction, WCC had received a warrant to purchase 111 shares of Cortec stock in connection with its financing of earlier purchases of the Cortec divisions. ¶ 15. The complaint alleges at ¶ 18 that the Offering Memorandum "stated that BHC was acting on behalf of the owners of Cortec, including WCC." WCC says that the italicized assertion is flatly contradicted by the Offering Memorandum itself, which it attaches to its motion papers. In any event, the complaint nowhere alleges that WCC had any communications with plaintiffs in connection with the transaction, or that WCC made any misrepresentations or fraudulent omissions. WCC returns

to the stage only in the form of an allegation that Acquisition entered into the Stock Purchase Agreement "with the Selling Defendants, WCC, and Woodlawn," pursuant to which "Acquisition agreed to purchase all of the Cortec shares and Cortec agreed to purchase and cancel the Westinghouse Warrant." ¶ 29. Finally, the complaint alleges that the transaction closed on May 12, 1989, and that:

"Holdings through Acquisition, acquired all of the Cortec shares and Cortec purchased and cancelled the Westinghouse Warrant."

The mechanics of the transaction are fleshed out in plaintiff's brief in opposition to WCC's motion at 9-10. "Old" Cortec purchased and cancelled WCC's warrant.

Simultaneously Acquisition purchased the shares of "old" Cortec. Acquisition then merged into Cortec which became, as "new" Cortec, a wholly owned subsidiary of Holdings.

Thus the following facts emerge. At the time of the transaction, WCC owned a warrant which if exercised entitled WCC, on conversion, to 111 Cortec shares. The warrant had not been exercised. WCC held no Cortec shares. In order to consummate plaintiff's purchase of Cortec, it was necessary to do something about the WCC warrant. The parties to the transaction took care of the matter by having the warrant's issuer, "old" Cortec, request WCC to surrender it. WCC did so, being compensated by part of the funds paid by plaintiffs. The

warrant having thus been disposed of, Acquisition purchased all of the issued Cortec shares, "old" Cortec merged into Acquisition, and "new" Cortec emerged as the successor in interest to Acquisition.

In short, WCC sold its warrant to "old" Cortec, which purchased the warrant and cancelled it as part of the closing between Acquisition and "old" Cortec. Plaintiffs stress that the purchase and cancellation of the warrant occurred simultaneously, but that element of timing does not change the commercial reality of the case. Specifically, that reality, prevents plaintiffs from characterizing WCC as a seller of securities to plaintiffs. At most, WCC was a seller to plaintiff's seller, i.e., "old"

Cortec, and that does not suffice for § 12(2) purposes. "[A] buyer cannot recover against his seller's seller." Pinter at 108 S.Ct. 2077 n.21.

There being no privity between WCC and the buyer of the securities in suit, WCC cannot be a statutory seller under Pinter unless WCC "solicited the sales in question for a financial gain." Wilson, supra at 1126. The complaint fails to allege such solicitation on the part of WCC. Apart from the conclusory phrase that BHC issued the Offering Memorandum "on behalf of the owners of Cortec, including WCC," there is no allegation that WCC furnished any information to BHC for use in the Offering Memorandum, or directly solicited plaintiffs in any fashion, or

participated in any of the misrepresentations and fraudulent omissions alleged in the complaint.[1] These allegations are insufficient to visit upon WCC the draconian provisions of Section 12," with its "liability for negligent misrepresentation." Wilson at 1126.

Plaintiff's claim under § 12(2) against WCC will be dismissed without leave to replead. Because WCC is

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1. If the Offering Memorandum itself is properly before the Court on this motion to dismiss, it would be pertinent to note BHC's statement on page one:

> The enclosed Memorandum has been prepared by Bowles Hollovell Conner & Co. from information furnished to us by Cortec Industries, Inc., Dubin Clark & Company, Inc. and other trade and

(Footnote continued on next page)

named only in the 17(a) and § 12(2) claims, the complaint will be dismissed as to WCC in its entirety.

The § 12(2) claims against the other defendants are considered infra.

The Civil RICO Claims

Plaintiffs assert a civil RICO claim against the "Selling Defendants." I dismiss that claim because the complaint does not allege a viable civil RICO cause of action. The complaint charges the Selling Defendants with conspiring to violate

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(Footnote 1 continued)

> statistical sources which we deemed reliable.

There is no reference to WCC as a source of information for the Offering Memorandum. Since at the time WCC possessed an unexercised warrant but no shares of Cortec stock, this is not surprising.

and violating 18 U.S.C. § 1962(c). That section makes it unlawful for persons employed by or associated with enterprises engaged in interstate or foreign commerce to conduct the affairs of such an enterprise "through a pattern of racketeering activity..." In H.J., Inc. v. Northwestern Bell Telephone Co., 109 S.Ct. 2893 (1989), the Supreme Court undertook to identify and define the ingredients and boundaries of a "pattern of racketeering activity." Justice Brennan's opinion commanded only a 5-4 majority, but it represents the Court's most recent articulation of the governing principles.

H.J. holds that a "pattern of racketeering activity" requires the combination of predicate acts related

to each other and continuity of conduct. 109 S.Ct. at 2900.

As for relatedness, the H.J. majority derived from Title X of the Organized Crime Control Act of 1970, of which RICO forced Title IX, the rule that to be related, predicate acts must have "the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events." Id. at 2901.

However, the Court continued, the relatedness of racketeering activities is not sufficient to satisfy § 1962's "pattern" element. "To establish a RICO pattern it must also be shown that the predicates themselves amount to, or that they otherwise constitute

a threat of, continuing racketeering activity." Ibid. (emphasis in original). As to continuity, the H.J. majority wrote:

> "Continuity" is both a closed- and open-ended concept, referring either to a closed period of repeated conduct, or to past conduct that by its nature projects into the future with a threat of repetition. See Barticheck v. Fidelity Union Bank/First National State, 832 F.2d 36, 39 (CA3 1987). It is, in either case, centrally a temporal concept - and particularly so in the RICO context, where what must be continuous, RICO's predicate acts or offenses, and the relationship these predicates must bear one to another, are distinct requirements. A party alleging a RICO violation may demonstrate continuity over a closed period by proving a series of related predicates extending over a substantial period of time. Predicate acts extending over a few weeks or months and threatening no future criminal conduct do not satisfy this requirement:

> Congress was concerned in RICO with long-term criminal conduct. Often RICO action will be brought before continuity can be established in this way. In such cases, liability depends on whether the threat of continuity is demonstrated. See S. Rep. No. 91-617, at 158.

Id. at 2902 (emphasis in original).

The civil complaint in H.J. alleged that at different times over the course of at least a six-year period telephone company officers and employees gave members of a state regulatory commission bries in order to obtain approval of unfair and unreasonable utility rates. The Court noted plaintiff's "claim that the racketeering predicates occurred with some frequency at least over a six-year period, which may be sufficient to satisfy the continuity requirement." Id. at 2906 (emphasis

added). The case was remanded to the district court for further proceedings consistent with the Court's opinion.

In Beauford v. Helmsley, 865 F.2d 1386 (2d Cir.) (en banc), vacated and remanded, 109 S.Ct. 3326, original decision adhered to, 893 F.2d 1433 (2d Cir. 1989), plaintiffs alleged that defendants made a number of material misrepresentations in an offering plan for the conversion of an apartment complex into condominiums. The plan was mailed to more than 800 addresses. The complaint alleged additional facts sufficient to justify an inference that defendants would in the future be making further, equally fraudulent amendments to the offering plan. The Second Circuit held these allegations sufficient to describe a

pattern of racketeering activity. The en banc majority and the three dissenting judges in Beauford agreed that the concepts of "relatedness" and "continuity" were crucial: and, in a departure from prior Second Circuit authority, observed that "our analysis of relatedness and continuity has shifted from the enterprise element to the pattern element." 865 F.2d at 1391. That shift presaged the Supreme Court's analysis in H.J., which had not yet been decided.

In Beauford the Second Circuit defined Congress' goal in defining "pattern of racketeering activity" as to exclude from the reach of RICO criminal acts that were merely "isolated" or "sporadic." Consequently, Judge Kearse wrote for

the en banc majority, "we must determine whether two or more acts of racketeering activity have sufficient interrelationship and whether there is sufficient continuity or threat of continuity to constitute such a pattern." Id. at 1391. Where the enterprise itself is associated with organized crime, that fact alone is sufficient to "tend to belie any notion that the racketeering acts were sporadic or isolated." United States v. Indelicato, 865 F.2d 1370, 1384 (2d Cir. 1989) (en banc, decided with Beautord).

> When, however, there is no indication that the enterprise whose affairs are said to be conducted through racketeering acts is associated with organized crime, the nature of the enterprise does not of itself suggest that racketeering acts will continue, and proof

> of continuity of racketeering activity must thus be found in some factor other than the enterprise itself.
>
> Beauford at 1391.

The complaint in Beauford was legally sufficient for these reasons:

> In sum, read with ordinary charity, the amended complaint alleged that on each of several occasions defendant had mailed fraudulent documents to thousands of persons and that there was reason to believe that similarly fraudulent mailings would be made over an additional period of years. These allegations sufficed to set forth acts that cannot be deemed, as a matter of law, isolated or sporadic.
>
> Id. at 1392.

The Supreme Court granted certiorari in Beauford, vacates the Second Circuit's judgment, and remanded the case to that court for further consideration in light of H.J. 109

S.Ct. 3236 (1989). The Second Circuit gave Beauford that mandated further consideration and adhered to its en banc decision. 893 F.2d 1433 (2d Cir. 1989).

See also Jacobson v. Cooper, 882 F.2d 717, 720 (2d Cir. 1989) (continuity is sufficiently alleged where related predicates extend over "a matter of years"); Official Publications, Inc. v. Kagle News Co., 884 F.2d 664, 666-68 (2d Cir. 1989) (allegedly fraudulent acts occurred "pursuant to a longstanding contract, over a considerable period of time"; contracts in suit were dated 1974 and 1980); Procter & Gamble v. Big Apple Industrial Buildings, Inc., 879 F.2d 10, 18 (2d Cir. 1989) ("the complaint must provide allegations sufficient to

infer that an enterprise exists, and that the acts of racketeering were neither isolated nor sporadic;" allegations sufficient which claimed "that defendants engaged in at least five separate fraudulent schemes").

In the case at bar, plaintiffs' RICO claim arises out of the single transaction in suit. BHC prepared the offering memorandum in December 1988. The conduct of which plaintiffs complaint culminated in the closing of the transaction in May 1989. The culmination of this single transaction only over five months of negotiating does not satisfy closed-end continuity. Nor do plaintiffs satisfy the alternative showing of open-ended continuity, since the complaint alleges no conduct "that by its nature

projects into the future with a threat of repetition." H.J. at 2902. On the contrary: the transaction was completed in May 1989 "old" Cortec has become "new" Cortec; the "Selling Defendants," on plaintiff's theory, have achieved their ill-gotten gains; and plaintiff sues for a rescission. That theory of recovery is antithetical to open-ended continuity.

The complaint fails to allege a viable RICO claim. The RICO cause of action will be dismissed without leave to replead.

The Claims Under § 10(b) of the 1934 Act

In the first cause of action plaintiffs charge the Selling Defendants, Ernst & Young and BHC with fraud in violation of § 10(b) of the

1934 Act. The second cause of action charges those defendants with aiding and abetting violations of § 10(b).

All defendants involved challenge the sufficiency of the pleading. They rely in large measure upon Rule 9(b), Fed.R.Civ.P.

Before analyzing the amended complaint, it is useful to review pertinent Second Circuit authority.

Rule 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." Rule 9(b) must be read together with Rule 8(a) which requires only a "short and plain statement" of

the claims for relief." Ouaknine v. MacFarlane, 897 F.2d 75, 79 (2d Cir. 1990); DiVittorio v. Equidyne Extractive Industries, Inc., 822 F.2d 1242, 1247 (2d Cir. 1987). On a motion to dismiss, the court assumes the truth of plaintiff's factual allegations, Ouaknine at 78, reads the complaint generously, and draws all inferences in favor of the pleader. Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989); Yoder v. Orthomolecular Nutrition Institute, Inc., 751 F.2d 555, 562 (2d Cir. 1985). But Rule 9(b) must be enforced so as to accomplish its three goals:

(1) providing a defendant fair notice of plaintiff's claim, to enable preparation of his defense;

(2) protecting a defendant from harm

to his reputation or goodwill; and (3) reducing the number of strike suits. DiVittorio at 1247.

To satisfy the particularity requirement of Rule 9(b), a complaint must adequately specify the statements it claims were false or misleading, give particulars as to the respect in which plaintiff contends the statements were fraudulent, state when and where the statements were made, and identify those responsible for the statements. Cosmas at 11. Where multiple defendants are asked to respond to allegations of fraud, the complaint should inform each defendant of the nature of his or its alleged participation in the fraud. DiVittorio at 1247. However, no specific connection between fraudulent

representations or omissions need be pleaded as to defendants who are insiders or affiliates personally participating in the statements at issue. DiVittorio at 1247 (offering memorandum); Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986) (same).

A complaint may adequately identify the statements alleged to be misrepresentations and properly indicate when, where and by whom they were made, yet still fail Rule 9(b) scrutiny if the complaint does not allege circumstances giving rise to a strong inference that defendant knew the statements to be false, Wexner v. First Manhattan Co., 902 F.2d 169, 173 (2d Cir. 1990), and intended to defraud plaintiff, Quaknine at 80; Beck v. Manufacturers Hanover Trust

Co., 820 F.2d 46, 50 (2d Cir. 1987), cert. denied, 484 U.S. 1005 (1988).

Knowledge is a state of mind. So is intent to defraud, or "scienter." While Rule 9(b) permits conditions of mind to be averred generally, the rule also requires that allegations of scienter be supported by facts giving rise to a "strong inference" of fraudulent intent. Ouaknine at 80; Beck at 50; Connecticut National Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987).

Allegations supporting an inference of fraudulent intent frequently include defendant's statement that a fact exists or an event will come to pass coupled with allegations that the fact did not exist or the event did not occur, and

circumstances indicating that the statement was false when made. See, e.g., Luce at 56 (alleged misrepresentation in offering memorandum that general partners would make an initial capital contribution of $385,000 and guarantee a $4.5 million construction loan accompanied by allegations that general partners contributed only $80,000 and did not guarantee the loan); DiVittorio at 1248 (offering memorandum's statement that proceeds of offering would be expended as quickly as possible accompanied by allegation that proceeds were never so applied, and estimate that property contained approximately 9,260,000 tons of coal accompanied by allegation that mines did not contain nearly that much).

See Ouaknine at 81 for a comparable analysis.

To satisfy the scienter requirement, a plaintiff need not allege facts which show a defendant had a motive for committing fraud, so long as plaintiff adequately identifies circumstances indicating "conscious behavior" by the defendant from which an intent to defraud may fairly be inferred. Cosmas at 13. However, where a particular defendant's motive to defraud is not apparent, the strength of the circumstantial allegations must be correspondingly greater. Beck at 50.

Allegations may be based on information and belief when facts are peculiarly within the opposing party's knowledge. Luce at 54 n 1.;

DiVittorio at 1247-48. However, that exception to Rule 9(b)'s general requirement of particularized pleading does not constitute a license to base claims of fraud on speculation or conclusory allegations. Where pleading is permitted on information and belief, a complaint must adduce specific facts supporting a strong inference of fraud or it will not satisfy a relaxed pleading standard. Wexner at 172.

In the case at bar, the most glaring deficiency is plaintiffs' consistent failure to inform each of these multiple defendants of the nature of his or its alleged participation in the fraud. The complaint alleges fraud against a number of entities and individuals.

One limited partnership, two corporations, and three individuals are lumped together as the "Dubin Clark Defendants." Ten individuals (one now deceased) are lumped together as the "Management Defendants." These two groups of defendants are then blended together as the "Selling Defendants" in what I can only describe as a "super lump." To this substantial number of entities and individuals plaintiffs add BHC, the investment banking firm involved in the transaction, and Ernst & Young, the accounting firm, as alleged participants in the fraud. But plaintiffs make no consistent effort to plead the participation of each defendant with particularity, leaving the defendants quite unable to derive

from the pleading that fair notice necessary to the preparation of a defense.

Plaintiffs say that no such particularity is necessary with respect to insiders or affiliates personally participating in the Offering Memorandum, the Stock Purchase Agreement, and its accompanying representations and warranties. BHC in particular quarrels with the complaint's characterization of its work product as a "offering memorandum;" BHC prefers "descriptive memorandum," and argues that the complaint does not sufficiently allege material falsehoods at the time the document was prepared. There is force to this contention, particularly since a main

thrust of plaintiffs' fraud theory appears to be that subsequent statements and representations, allegedly fraudulent, caused plaintiffs to accept the accuracy of statements originally contained in the Offering Memorandum (as I will continue to call the document). Conceptually, however, a statement may be true when made but facts there after change, so that subsequent reiteration of the original statement is false. In addition, plaintiffs rely in part upon the Offering Memorandum's description of what Cortec management intended to do, namely, exercising "excellent control" over credit extension and accounts receivable. It is well settled that "[m]making a specific promise to

perform a particular act in the future while secretly intending not to perform may violate Section 10(b)...if the promise is part of the consideration for the sale of securities." Pross v. Katz, 784 F.2d 455, 457 (2d Cir. 1986).

Plaintiffs justify their collective pleading on the ground that no particularization is required with respect to defendants acting fraudulently as a group. There is some authority for that proposition, found in the cases which do not require specific connection between fraudulent representations or omissions and particular defendants when those defendants are insiders or affiliates personally participating in the allegedly fraudulent statements.

That concept of relaxed pleading is based upon true common sense proposition that the particular contributions of a group of insiders or affiliates to a fraudulent document lies particularly within such defendants' knowledge, and the circumstances entitle the pleader to presume that the fraud entails the collective actions of insiders. But that rule of relaxed pleading has no office to perform where, as in the case at bar, plaintiffs expand their allegations of fraud beyond the original offering documents, and charge defendants with subsequent fraudulent statements to plaintiffs themselves during the period between the initial offering and the closing of the transaction. As to such

misrepresentations or fraudulent omissions, plaintiffs cannot be heard to say that the knowledge lies particularly within defendants' control. Plaintiffs must know who said what to them, when, and in what form. The individual defendants are entitled to these particulars, but they do not find them in the complaint.

That deficiency in the pleading leads naturally to the conclusion that the complaint is also deficient with respect to its allegations of scienter as to the particular defendants. As to BHC, the investment banking firm, plaintiffs face an added obstacle because the law of this circuit is that a client's knowledge of falsity or fraudulent intent cannot be imputed to its investment adviser solely on

the basis of the professional relationship between them. To state a viable claim for fraud against the investment adviser, the complaint must allege more than that. See Devaney v. A.P. Chester, 813 F.2d 566, 568 (2d Cir. 1987):

> The complaint does not allege any facts to suggest who at Salomon Brothers possessed such knowledge, when and how they obtained the knowledge, or even why anyone at Salomon Brothers should have known that the views expressed in the Prospectus did not represent the true beliefs of AMI Management.

Such a pleading is entirely conclusory, and does not "allow for an inference, let alone a strong one, regarding Salomon's knowledge." Id. at 568-69 (quoting the district court). The complaint at bar is no better. This is a deficiency with respect to

plaintiffs' allegations of fraud on the part of BHC in connection with preparing the Offering Memorandum. When the focus shifts to later communications and reassurances, the complaint is as deficient concerning BHC in its failure to particularize individual participation as it is with respect to all other defendants.

As for the accounting firm, Ernst & Young, to the extent the firm is lumped in with other "defendants" in allegations of fraud the pleading is deficient for reasons already stated. However, plaintiffs' charge against Ernst & Young is more sharply focused. The main thrust of their claim of fraud against Ernst & Young relates to the comfort letter which Ernst & Young delivered to plaintiffs

just before the transaction closed. There is accordingly no doubt as to who said what to whom and in what form, with the context of plaintiffs' claim against the accountants.

Nonetheless the complaint in its present form is insufficient. That is because ¶ 36 of the complaint only partially quotes the comfort letter, and that partial quotation is marred by a significant ellipsis. In alleging pre-closing events and at the closing, plaintiffs say that they received Cortec's internal financial statements for January, February and March 1989. The January financial statements so alarmed plaintiffs with respect to the level of accounts receivable that the deal almost fell through. But the February and March

1989 financial statements were more encouraging, and so the transaction got back on track, ultimately resulting in a Stock Purchase Agreement which provided, inter alia, that Ernst & Young "would deliver 'a comfort letter' to Acquisition concerning the first quarter 1989 financials." ¶ 30(b). The accountants' delivery of that comfort letter is alleged in ¶ 36, where plaintiff alleges:

> With respect to Arthur Young's audit of the January 1, 1989 financial statements of Cortec and its review of financial statements provided plaintiffs subsequent to the date, Arthur Young represented that "nothing came to [its] attention . . . that caused [it] to believe that the [financial statements] are not in conformity with generally accepted accounting principles applied on a basis substantially consistent with

> [the January 1, 1989 audited financial statement]," with minor, irrelevant exceptions.

The ellipsis in the comfort letter requires that the missing words be filled in, even though plaintiffs did not attach the letter as an exhibit to the complaint. If a legal maxim be required to justify the procedure, the equitable doctrine of completeness will do. In point of fact, the missing words are "as a result of the foregoing procedures." Ernst & Young's Reply Brief at 5. Thus the "representation" made by Ernst & Young in its comfort letter was that "nothing came to [its] attention as a result of the foregoing procedures that caused [it] to believe that the [financial statements] are not in conformity with generally accepted

accounting principles applied on a basis substantially consistent with [the January 1, 1989 audited financial statement]..."

This is, if I may put it that way, a material omission from the complaint, because one cannot tell from the pleading what particular procedures were bargained for or described as having been made in the comfort letter. But without knowing those details, one cannot know the scope of Ernst & Young's representation; nor can such crucial elements as knowledge of falsity, recklessness, or scienter be properly evaluated. The consequence of this analysis is that the § 10(b) claims against all defendants will be denied with leave to replead.

The § 12(2) Claims Against Other Defendants

The deficiencies in the § 10(b) fraud claim allegations are not necessarily fatal to plaintiff's § 12(2) claims against those defendants who are indisputably statutory sellers. That is because statutory sellers soliciting the sales in question for a financial gain may be liable under § 12(2) for negligent misrepresentation, whether or not scienter or loss causation is shown. Wilson, supra at 1126.

With the exception of WCC, discussed supra, and Ernst & Young, not included in plaintiffs' § 12(2) claim, the defendants are sufficiently alleged to be statutory sellers under § 12(2). The complaint also sufficiently alleges liability for

negligent misrepresentation on the part of these defendants. Plaintiffs on this aspect of the case need not allege or prove scienter or loss causation. § 12(2) establishes strict liability on the part of the seller of securities for material misrepresentations and omissions. Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988).

Accordingly the motions of these defendants to dismiss the § 12(2) claims are denied.

The Other Claims

Because plaintiffs allege a viable federal claim as to certain defendants, I will exercise jurisdiction over properly pleaded state and common law claims.

The sixth cause of action against the Selling Defendants and BHC for

common law fraud is dismissed with leave to replead.

The motion of defendants Sum Holding and Yerke to dismiss the seventh cause of action alleging breach of contract is denied.

The motion of Ernst & Young to dismiss the eighth cause of action is granted, but with leave to plaintiffs to replead their § 10(b) claim against Ernst & Young, which if successfully accomplished will revive this pendent common law claim.

CONCLUSION

For the foregoing reasons the Clerk of the Court is directed to dismiss the complaint in its entirety as to defendant Westinghouse Credit Corp. without leave to replead; to dismiss the fourth and fifth causes of action as against the defendants named therein without leave to replead; and to dismiss the first, second, and sixth causes of action with leave to replead. The remaining motions to dismiss the complaint are denied consistent with this Opinion.

If plaintiffs elect to replead, they must file and serve an amended complaint within sixty (60) days of the date of this Opinion. Plaintiffs and counsel must be mindful of Rule 11.

There being no just cause for delay, the Clerk of the Court is

directed to enter a final judgment in favor of defendant Westinghouse Credit Corp. Rule Fed.R.Civ.P. 54(b).

It is SO ORDERED.

Dated: New York, New York
January 3, 1991

CHARLES S. HAIGHT,
JR. UNITED STATES
DISTRICT JUDGE

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